

Monetary and Exchange Rate Policies in an Open Economy :
The Malaysian Case, 1959-1992

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ABSTRAK

Tujuan utama kertas ini adalah untuk menganalisa peranan kadar pertukaran asing dan dasar kewangan dalam konteks sebuah negara kecil yang mempunyai ekonomi terbuka dan juga untuk membincang interaksi kedua-dua dasar tersebut. Pengalaman Malaysia menunjukkan bahawa terdapat interaksi yang rapat dan kadangkala tukar ganti ("trade-off") di antara dasar kadar pertukaran asing dan kewangan. Pengalaman Malaysia terutamanya dalam tahun 1992 menunjukkan bahawa dasar penstabilan perlu dilihat secara menyeluruh dalam perspektif yang betul. Kedua-dua dasar kadar pertukaran asing dan kewangan mesti dilaksanakan sebagai satu pakej langkah makroekonomi yang bersepadu. Oleh itu, untuk menggalakkan pertumbuhan ekonomi jangka panjang yang stabil, penyelarasan di antara kesemua dasar, sama ada dalam negeri atau di antara negara, adalah perlu.

ABSTRACT

The main purpose of this paper is to analyse the role of the exchange rate and monetary policy in a small open economy and to discuss the interaction of these policies in the Malaysian context. The Malaysian experience indicates that there is a close interaction and sometimes a trade-off, between monetary and exchange rate policies. The experience of Malaysia, particularly in 1992, underscores the need to view stabilisation policies in their totality within the proper perspective. Both exchange rate and monetary policies must be seen as part and parcel of an integrated package of macroeconomic measures. In addition, there is a need for co-operative actions across the full range of policies, both domestically and across countries, in order to promote stable long-term economic developments.

INTRODUCTION

Malaysia is essentially an open developing economy with exports and imports of goods representing about 74% and 72% of GNP, respectively, in 1992. Malaysia was, until recently, very much an agricultural economy but industrial development has been rapid in the past decade. The share of the manufacturing sector in the economy, at 29% of GDP in 1992, has since surpassed that of agriculture (17% of GDP). The major trading partners of Malaysia comprise Japan, Singapore and the United States, which together represented about 55% of the total exports and 58% of the total imports of Malaysia in 1992. Since her independence in 1957, the country has consistently achieved a high rate of growth, except during the period 1983-1986. The main purpose of this

paper is to analyse the role of exchange rate and monetary policies, and discuss the interaction of these policies within the context of the Malaysian economy.

MONETARY POLICY 1959 - 1992

Objective

The principal macroeconomic objective of the monetary policy in Malaysia is to promote the highest sustainable rate of output growth, consistent with domestic price and exchange rate stability. In working towards this objective, the Central Bank seeks to maintain monetary stability by ensuring that the growth in bank credit and money supply are adequate to accommodate and fuel real growth in the economy, without causing inflationary pressures.

Since monetary policy operates through financial markets, the Central Bank must ensure that the economy has a sound banking and finance industry as well as markets which are orderly, efficient and, whenever needed, innovative. Besides the Central Bank, many other forces also affect the flow of money and credit in the economy. This is why the national economic objective can only be obtained through the co-ordinated implementation of monetary, fiscal and other policies of the Government.

Targets

The Bank uses various measures of money supply namely M1, M2 and M3 as intermediate targets, through which it seeks to influence the broad macroeconomic variables. While the Bank currently places more emphasis on M3, which is the broadest monetary aggregate available, the Bank concomitantly looks at a broad range of indicators to gauge the current and prospective state of the flow of liquidity in the financial system and the economy, and evaluates the impact of monetary measures. As a practical matter, monetary management has been guided by the growth in monetary aggregates as well as the level of interest rate. However, the underlying variable of main concern to monetary policy is bank liquidity.

Monetary Instruments

The monetary instruments used in the conduct of monetary policy in Malaysia include the traditional open market operations (OMO) and variations in reserve and liquidity requirements. However, due to limitations in the use of OMO (in the traditional sense) and the inflexibility associated with reserve and liquidity requirements and the growing complexity of monetary management since the 1980s, other conventional instruments have also been employed and non-traditional policy instruments devised and introduced. Among them are the centralisation (for management and recycling) of the Government's surplus balances at the Central Bank, direct action to borrow or lend by the Central Bank in the money and interbank markets, and the issues of and intervention through Central Bank debt certificates. Selective monetary measures involving the control of hire purchase and stock purchase

margins, as well as the direct use of credit ceilings are also used.

THE CONDUCT OF MONETARY POLICY

The stance of monetary policy at any time generally reflects the Central Bank's reaction to the prevailing economic situation. Monetary policy turns expansionary, as in 1975 and 1985-86, to help stimulate economic recovery or to avoid the threat of an economic downturn. On the other hand, a restrictive or contractionary monetary policy works to dampen inflationary pressures and to promote savings, as in 1981 and 1989-1992. There are also occasions when monetary policy can be said to be rather neutral, as in 1987 and 1988.

In Malaysia, deliberate monetary management only began with the establishment of the Central Bank in January 1959. In the 1960s, monetary policies were designed to strengthen and further develop the existing financial framework and establish new institutions and markets. The Bank relied mainly on interest rates as a policy instrument. However, with the emergence of unsettling and destabilising international monetary conditions in the 1970s, monetary policy was directed at maintaining monetary stability and a strong and stable currency and to further the growth and development of sound financial intermediation.

Economic and monetary management during the early 1980s was confronted with multiple challenges posed by a prolonged global recession, the consequent slowdown in domestic economic activity, a sharp deterioration in the Government's finances and a ballooning balance of payment deficits. Under these circumstances, the overall stance of monetary policy was selectively restrictive to counteract fiscal expansion. A major feature of this policy was to allow a gradual rise in the general level of interest rates in response to growing demand, in order to promote and retain domestic savings as well as to protect the balance of payments. At the same time, the Central Bank was concerned that high interest rates could undermine business confidence, and hence, adversely affect the prospects for an early revival. Therefore, while keeping to its moderate

monetary expansion stance on one hand, the Central Bank had, on the other hand, intervened in the money market to dampen interest rate volatility. In the mid-1980s, the Central Bank's policy shifted to being more expansionary to counteract the tightening money market conditions arising from the onset of the subdued international environment and depressed commodity prices. This was done mainly through open market operations, foreign exchange swaps, the recycling of Government deposit and reduction in the statutory reserve and liquidity requirements of commercial banks. Again, the Bank had to manage interest rates judiciously.

The scenario, however, changed in late 1986 when the economy began to recover. The improvement in commodity prices, strong performance of manufactured goods and continuing inflows of direct foreign investments caused the banking system to be flushed with funds. To ensure that these funds would not generate any inflationary tendencies and to prevent interest rates from collapsing, the Central Bank assumed a more active role to neutralise much of the excess liquidity. Overall, the stance of monetary policy over the period 1987 - 1988 can be considered neutral. When pressures on prices started to build up in 1989 as evidenced by the level of excess demand and monetary expansion, the Central Bank became more concerned about excess liquidity in the banking system for fear of building up inflationary expectations. Accordingly, the Central Bank conducted a contractionary policy to mop up large pockets of excess liquidity, mainly through open market operations, direct borrowings from the market and raising the statutory reserve requirements of the banking institutions. This helped to ease inflationary expectations and raise interest rates to reasonable levels.

The thrust of monetary policy in 1990 - 1992 was to manage excess liquidity with the main objective of easing latent inflationary pressures, while sustaining the growth momentum. Given the large overhang of excess liquidity from previous years in the financial system, which was accentuated by continued large capital inflows from abroad and the rapid expansion of bank credit, the Central

Bank continued to pursue a tight monetary policy stance in order to contain inflationary pressures, emphasising the tightening of bank liquidity and money supply as well as the promotion of domestic savings. Consequently, interest rates rose but with little dampening effects on economic activity.

EXCHANGE RATE POLICY 1959 - 1992

The exchange rate policy of Malaysia has evolved radically over time. Indeed, the experience of exchange rate management (and performance) in Malaysia was very much influenced by the changes in the international monetary system and the increased uncertainty in the international trading environment associated with the large and often random fluctuations in the exchange rates of major currencies (Lin, 1991a, 1991b).

Background on Exchange Rate Regimes and Practices in Malaysia

Prior to June 1973, a fixed exchange rate arrangement existed in Malaysia and the exchange rate of the ringgit was influenced primarily by developments in the sterling. The exchange rate of the ringgit was initially pegged to the sterling, and from June 1972, to the U.S. dollar. In the face of continuing uncertainty in the international foreign exchange markets, however, the ringgit was allowed to float upwards against the U.S. dollar in June 1973 to permit the exchange rate to better reflect the prevailing market conditions.

Subsequently, in September 1975, to maintain orderly and stable exchange rates, the Malaysian Government adopted a new exchange rate regime whereby the value of the ringgit would be determined in terms of a basket of representative major currencies, instead of the U.S. dollar alone. The basket of currencies was weighted on the basis of the major currencies of settlement as well as the trade shares of the major trading partners of Malaysia. This exchange rate arrangement has since continued to form the basis of the existing exchange rate policy of the country. With this arrangement, the value of the ringgit has been fluctuating relative to the basket, in line with prevailing conditions in the economy

in general, and supply and demand conditions in the foreign exchange market in particular. As a matter of policy, interventions by the Central Bank in the exchange market were made only to stabilise the market.

THE POLICY TO ACHIEVE EXCHANGE RATE STABILITY, 1976 -1984

A major policy focus in Malaysia during the early period of the floating exchange rate regime was to maintain relative stability and minimise fluctuations in the exchange rate of the ringgit. The policy of exchange rate stability was consistent with the more fundamental objective of preserving the overall price stability in Malaysia, especially by minimising the extent of imported inflation transmitted to the country, which could result from sharp exchange rate depreciations. Indeed, the ringgit was maintained relatively stable during the period 1976-1980, in the face of strong improvements in the merchandise and current account balances of the balance of payments. The official composite index fluctuated between 100 (the base in September 1975) and 102. Since 1979, however, weaknesses in the balance of payments began to surface. The onset of the global recession resulted in lower demand for Malaysia's exports and consequently, a significantly weaker merchandise balance position. The ringgit, therefore, weakened by 4% against the composite, from 102.8 in 1979 to 98.6 in the final quarter of 1980.

The deterioration in the balance of payments position worsened further in the period 1981- 1984, with the current deficit peaking in 1982-1983 at over RM8 billion annually. Despite this, the ringgit regained strength in terms of the composite basket although it weakened moderately against the U.S. dollar. During the period 1981-1984, the official composite index moved within the range of 103.5 and 109.5 which, in some instances, represented an appreciation of ringgit of up to 5% a year. This seemingly contradictory development in the balance of payments and exchange rate movements reflected several important considerations. The large balance of payment deficits could be

traced to the Government's counter-cyclical fiscal policy in the early 1980s to ride out the global recession. Increased Government expenditure had resulted in large overall budgetary deficits, financed through significant foreign borrowing, thereby increasing the country's external debt (RM37.6 billion at the end of 1984).

Higher foreign borrowing was reflected in larger inflows of official long-term capital in the balance of payments. The inflow of loan proceeds created a demand for the ringgit, which restrained the currency from depreciating despite the poor current account position prevailing during the period. It is interesting to note here that the Malaysian experience reflected the gradual shift, globally, from conditions in the current account to movements in the capital account in the determination of exchange rates over the short run. While this has been increasingly true in the case of many developed countries, it does appear that the role of capital movements has become increasingly influential in the determination of exchange rates in the developing countries as well, particularly those with a relatively developed capital market.

Another contributory factor to the appreciation of the ringgit during 1980 -1984 was the periodic intervention operations of the Central Bank. Although the policy at the time was to keep the ringgit relatively stable against the Singapore dollar, intervention through the U.S. dollar kept the ringgit relatively strong *vis-a-vis* the U.S. dollar. Consequently, during 1981- 1983, the premium of the Singapore dollar over the ringgit was maintained at about 9%, while the depreciation of the ringgit against the U.S. dollar was kept at 4.3%.

Looking back, this policy stance had clearly generated definite costs to the economy. However, the strong currency had helped to contain the impact of imported inflation in Malaysia and to some extent, sustain confidence in a fundamentally weak economy. Private investment remained relatively strong, growing at an average rate of 10.9% a year, and real GDP growth averaged 6.9% annually during the period.

The appreciation in the ringgit exchange rate later proved to be unsustainable. The weakening of the other ASEAN currencies,

together with the nervous foreign exchange markets abroad associated with the strong U.S. dollar, caused bouts of speculation on the ringgit. The growing twin deficits in the external and fiscal accounts further increased the frequency and intensity of these attacks. In October 1984, the speculative bubble burst. The Central Bank promptly diffused the pressure on the exchange rate through heavy interventions in the market to restore market stability. Moreover, in the period after the speculative attack in October 1984, the thrust of exchange rate policy was redirected from trying to maintain the relative stability of the ringgit *vis-a-vis* the U.S. and Singapore dollars to one that relied increasingly on market forces to determine the principal exchange rates. Indeed, from 1985, the ringgit depreciated against the composite, the Singapore dollar and all major currencies except for the U.S. dollar. The long period of progressive depreciation generally continued into 1990, before the ringgit turned around to appreciate against certain major currencies in 1991 and against all major currencies in 1992.

POLICY SHIFT TOWARDS MARKET BASED EXCHANGE RATES, 1984-1992

Dissatisfaction with the performance of the floating exchange rate system had caused the major countries to move away from a regime of independent floating towards a co-ordinated-floating arrangement, particularly since the Plaza Accord on September 22, 1985. The Accord by the G-5 countries was motivated by sharp fluctuations in the U.S. dollar, which rose to record levels against the Japanese yen and the major European currencies in February 1985, and subsequently weakened. The Accord enabled the G-5 countries to undertake concerted intervention to bring about further depreciations in the U.S. dollar *vis-a-vis* the Japanese yen and the Deutschmark to reflect better the economic fundamentals of the respective economies.

The ringgit exchange rate benefited from this realignment exercise as it helped to speed up the depreciation of the ringgit from its unrealistically high level during 1981-1984. From the time of the Plaza Accord to the end

of 1985, the ringgit depreciated by 8.6% against the composite. In 1986, another large 13.7% depreciation of the ringgit against the composite was recorded. The adoption of the Louvre Accord in February 1987, whereby central banks of the major industrial countries committed to maintain an exchange value within specified targets of around Y153 and DM1.84 to the dollar, also helped speed up the ringgit depreciation. Indeed, the ringgit depreciation against virtually all major currencies continued unabated until March 1989. By this time, the ringgit had depreciated by 27.8% against the composite, 19.3% against the Singapore dollar, 50.3% against the yen, 27.5% against the pound sterling and 40.6% against the Deutschmark since the Plaza Accord. However, a lower depreciation of 9.2% against the U.S. dollar was recorded. In real effective terms, the ringgit had depreciated by 27.9% during the period 1985-1988.

It should be noted that the policy stance to free the movements of the ringgit *vis-a-vis* the U.S. and Singapore dollars in late 1984 was a major factor contributing to the subsequent sharp depreciations in the ringgit exchange rate, which in turn contributed to significant gains in the level of international competitiveness achieved since 1985. The policy was implemented at the time when inflation rates were extremely low, so that the threat of imported inflation posed by currency depreciations was virtually non-existent. In addition, after economic growth had plunged to -1.1% in 1985 and rose by a marginal 1.2% in 1986, the gains in international competitiveness arising from currency depreciations were instrumental in stimulating export growth, which turned the economy around in 1987 and accelerated the growth process to record an expansion rate of close to 10% in 1990.

Reflecting the deterioration in the current account deficit in the balance of payments in 1991, the rate of depreciation of the ringgit moderated to 2.9% against the official composite in 1991 from 6.3% in 1990. However, the exchange rate was never managed as a tool to correct the external imbalances. The external imbalances were viewed as the result of structural changes facing the economy. The competitive position of Malaysia had resulted in large-scale increases

in direct foreign investments, which necessitated large imports of capital and intermediate goods. Since such imports were financed by long-term foreign capital, the country did not face financing constraints. However, the situation reversed significantly in the first half of 1992. By July 15, the ringgit had appreciated across the board. The strengthening of the ringgit was due mainly to higher interest rate differentials in favour of ringgit *vis-a-vis* other currencies, which attracted substantial inflows of capital following the tightening of monetary conditions since 1989 as well as the bearish sentiments for the U.S. dollar in the international foreign exchange markets, arising from the weak economic recovery of the United States.

INTERACTION BETWEEN MONETARY AND EXCHANGE RATE POLICIES

Exchange rate and monetary policies interact closely. It was generally considered in the 1950s and 1960s that flexible exchange rates would render a country a greater degree of independence and effectiveness in the conduct of its monetary policy. Unfortunately, the experience with floating exchange rates in a period spanning over two decades has not been all that successful. The globalisation of financial markets had contributed to the presence of a high degree of capital mobility across countries and the interplay of massive amounts of capital with no allegiance to any single nation. These had tended to obscure, and even reduce, the advantages of the floating regime over the fixed regime.

POLICY TRADE-OFFS IN DEVELOPING COUNTRIES

In light of the above, countries all over the world today are still grappling with the choice of the appropriate mix of monetary and exchange rate policies in the design and conduct of an overall macro-economic stabilisation programme. For developing countries, the precise manner by which monetary policy interacts with exchange rate policy is not always clear and straightforward. While, at times, separate and distinct monetary

and exchange rate policies can be implemented to achieve certain economic goals, there are also times when these two policies (forced by circumstances) are reduced effectively to a single policy aimed at achieving a specific objective. It is in this context that the issues of the trade-off between monetary and exchange rate policies often arise.

The difficulty in the conduct of separate and distinct monetary and exchange rate policies stems from several reasons which are inter-related. First, most developing countries by their very nature do not have well-developed financial and capital markets for the effective conduct of stabilisation policies. Second, a lack of instruments, particularly the inability to undertake extensive open market operations, has hindered the flexible implementation of monetary policy. Third, developing countries are susceptible to frequent and prolonged attacks on their currencies as well as massive flights of capital which are often attributable to non-economic considerations. And finally, developing countries tend to regard inflation, interest rate and exchange rate as important targets in themselves, which these countries attempt to control simultaneously. All these would imply that the policy requirements in developing countries are many and varied, and the lack of adequate policy instruments could only worsen the situation further.

Nevertheless, some developing countries have recorded considerable success in their conduct of monetary and exchange rate policies, which are distinct and separate from each other. Thailand, Indonesia and Korea, in the early 1980s, used monetary policy primarily to preserve price stability whereas the exchange rate policy was used to promote international competitiveness. However, while it is easy in theory, it may be difficult, in practice, to assign specific policies to achieve specific objectives. In the final analysis, the bottom line is what works and makes the most practical sense to effectively implement, to meet national objectives.

THE MALAYSIAN EXPERIENCE

The management of exchange rate and monetary policies in Malaysia since the Plaza Accord, has had its share of difficulties and

challenges. In 1986, for example, speculative pressures stemming from expectations of a sharp depreciation of the ringgit led to significant capital outflows. To diffuse these pressures, the Central Bank tightened bank liquidity considerably, driving interest rates to record levels, particularly during the months of April-May 1986. Financial policy management was difficult, given the conflicting objectives of maintaining stability in the foreign exchange market through high interest rates, and simultaneously, keeping interest rates low and stable in the money market and banking system to promote greater private investment in the face of the recession in 1985 and 1986. As a result, priority in the shortrun was given to maintaining stability in the value of the ringgit against mounting speculative pressures, so that high interest rates had to be tolerated as a short-run phenomenon. While further injections of liquidity into the system would leak abroad, Central Bank expansionary operations (RM4.4 billion during January - October 1986) helped to prevent further rise in interest rates, which came down considerably towards the end of the year when exports and commodity prices began to strengthen. Therein lies the necessary trade-off between exchange rate and monetary policies, which the authorities must occasionally face under the present exchange rate regime.

Another period when the conduct of monetary and exchange rate policies was tested was in 1973 when the country encountered the real threat of imported inflation in the face of significant upheavals in the performance of world economy and international financial system following the first oil crisis. When the ringgit was allowed to float in June 1973, its performance initially was highly unstable. Malaysia's monetary policy was directed at ensuring that the sharp external fluctuations did not unduly hamper the process of orderly and balanced expansion in domestic economic activities. A combination of instruments was used to restrain credit expansion, encourage savings and direct the flow of credit to raise productive capacity. These measures included raising interest rates, floating Government bonds to mop up excess liquidity and direct Government action to stabilise food prices.

Despite all these measures, inflation remained high. The experience of 1973 clearly indicated the limitations of monetary policy in stabilising the economy, especially when the financial structure was not fully developed.

Another challenge to the conduct of monetary and exchange rate policies in Malaysia emerged in 1989 and 1992 in the form of excess liquidity arising from strong inflows of foreign capital. Despite the significant increase in loans by the banking system, excess liquidity amounted to almost RM3 billion at the end of 1989. As a result, narrow money M1 rose by 19.1% and M2 by 16.2%, while broadly defined money supply, M3, rose by a more significant 20.6% (8.1% in 1988). Consequently, the interest rate differential was 3.7 percentage points in favour of Singapore and 3.8 percentage points in favour of the United States, compared with Malaysia. Quite naturally, the large liquidity overhang posed potential threats to the economy from rising inflationary expectations and possible outflows of capital seeking attractive returns abroad. As a result, proper management of the monetary and exchange rate policies was required to prevent the translation of these threats into reality.

The exchange rate policy in 1989 was to maintain relative stability and guard against the erosion in the level of international competitiveness. Although this was successfully achieved, the task of monetary policy centred on managing excess liquidity in the face of substantial capital inflows and a sharp increase in credit demand, was more trying. The tight monetary stance was maintained to the present day with the objective of containing inflationary pressures. This stance was pursued through various means : open market operations, direct borrowing from the market, recycling of Government deposits and raising the statutory reserve requirements of the banking institutions. In addition, controls on consumer credit and credit cards were tightened in 1991. As a result, the expansion of money supply (M3) fell to 14.2% at the end of March 1992 from 20.6% at the end of 1989. However, in view of the continued large inflow of funds into the country, the decline in the money supply was not sustained in the

second quarter of 1992, when M3 grew by 20.1% at the end of June 1992.

The tight monetary policy stance adopted by the Central Bank since 1989 led to a firming of interest rates. With the domestic interbank rate rising and interest rates abroad declining, the interest rate differential shifted in favour of Malaysia for the first time in 1991 since the mid-1980s. By July 7, 1992, the interest rate differential in favour of Malaysia was 5.6% compared with Singapore, 4.6% compared with the United States and 5.1% compared with Hong Kong.

The conduct of monetary policy in the first half of 1992 was made more difficult by the consequent widening of interest rate differentials between domestic *vis-a-vis* foreign rates. This development resulted in massive inflows of short-term capital into the country and contributed to a sharp appreciation of the ringgit in the first half of 1992. The Central Bank, therefore, conducted contractionary operations, causing interest rates to remain firm and attracting strong capital inflows, which in turn exerted more pressures on the ringgit to further appreciate.

CONCLUSION

Past Malaysian experience as a small open economy indicated that there was a close interaction, and sometimes a trade-off, between monetary and exchange rate policies. This can best be summarised as in Figure 1.

Looked at differently, the interaction of monetary and exchange rate policies can (and does) lead to situations where the objectives of policies need not necessarily be consistent. Indeed, situations of conflict or dilemma do develop, as shown in Figures 2, 3 and 4.

Situation D best describes the 1992 situation in Malaysia - the interaction of monetary and exchange rate policies promotes both price stability and a strong capital account, but is not the best for promoting further growth. This is best illustrated in Figure 3.

Restrictive monetary policy and a strong currency present no dilemma so long as the policy is not to pursue further strong growth at the same time. As the growth process matures, the objectives of continuing price stability (low inflation) and a strong basic balance of payments position are not inconsistent with tight monetary policy and a strong exchange rate (see Figure 4).

What is implicit here is that there are limits to the use of monetary and exchange rate policies. Monetary policy alone however, no matter how sound and prudent, cannot do the job of short-term stabilisation and the promotion of stable long-term economic development. There is a need for co-operative actions across the full range of policies, both domestically and across countries. Proper co-ordination of monetary and exchange rate policies can help to contain speculative tendencies in the markets, but these are not substitutes for well-coordinated and reinforcing actions in the fiscal and structural areas to deal with the underlying conditions. Furthermore, the interrelationship and interdependence among national economies have also made it imperative, in the formulation of domestic policies, to take into account the policies of other countries and to understand the way in which economic policies and exogenous shocks are transmitted among countries. Finally, to further sharpen the efficacy of monetary and exchange rate policies, the Central Bank needs to push on with its programme of financial reforms to raise in particular the efficiency of the transmission mechanism for policy. The great urgency, of course, is the need to broaden and deepen financial markets in the country in the desire to render greater efficiency and stability to these markets, as well as raise the effectiveness of monetary policy. In this regard, the Government has adopted important measures to reform the capital market to make it more efficient and responsive to the needs of the private sector, as the latter assumes its rightful place as the permanent engine for a growth in the economy.

FIGURE 1 : Compatibility of Policy Objectives

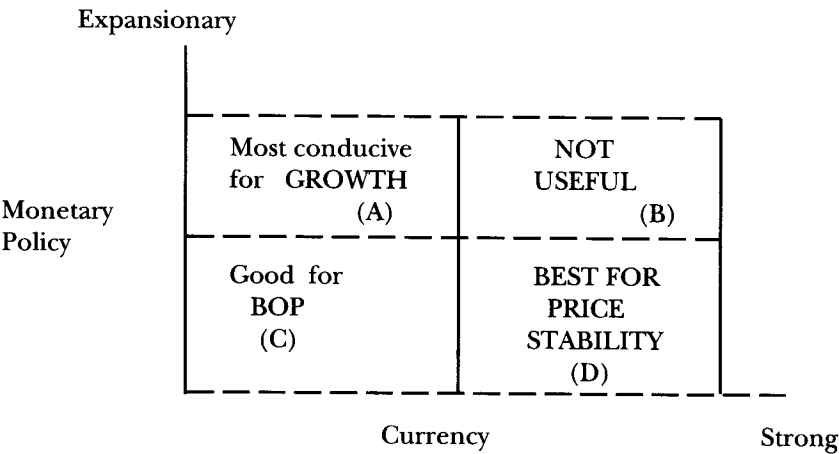
Policy Objectives	Monetary Policy (interest rate)	Exchange Rate Policy
Growth & Employment	Low interest rate	Weak Currency
Price Stability	High interest rate	Strong Currency
Strong BOP	High interest rate	Weak (Current)* Strong (Capital)

* A weak currency is compatible with a strong current BOP
A strong currency is compatible with a strong capital BOP

Observations :

- 1. Price stability and strong BOP are compatible objectives
- 2. Growth is incompatible with strong BOP or price stability

FIGURE 2 : Compatibility of Instruments *vis-a-vis* Policy Objectives



- A : Optimal Growth
- 1. Expansionary Monetary Policy (MP) & Easy Credit Policy (CP)
 - 2. Weak Exchange Rate
- B : Objectives of Policy Conflict
- 1. Expansionary Monetary Policy & Easy Credit Policy
 - 2. Strong Exchange Rate
- C : Best for BOP
- 1. Restrictive Monetary Policy & Tight Credit Policy
 - 2. Weak Exchange Rate
- D : Best for Price Stability
- 1. Restrictive Monetary Policy & Tight Credit Policy
 - 2. Strong Exchange Rate

FIGURE 3 : Conflicting Objectives

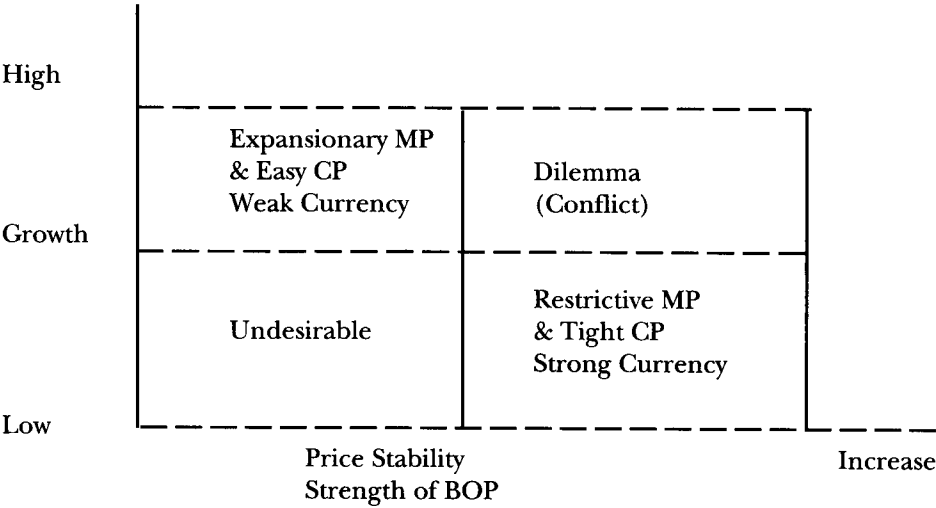
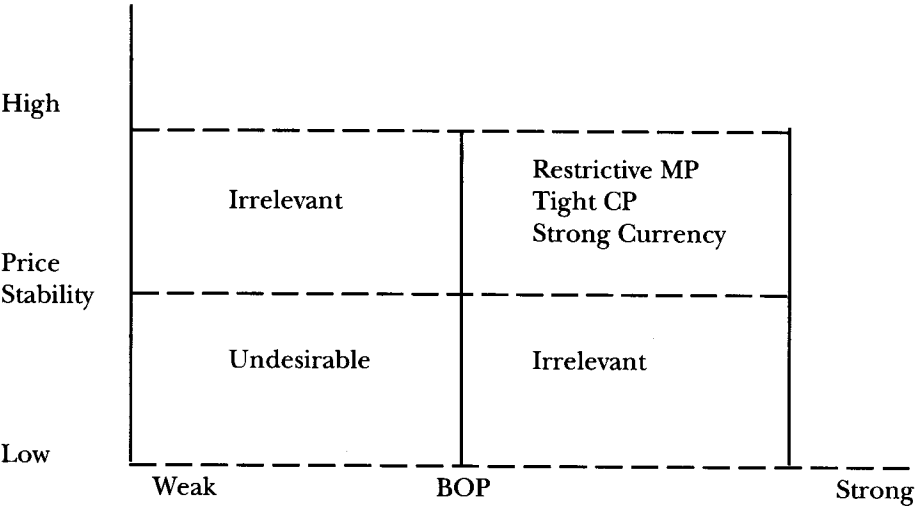


FIGURE 4 : Compatibility of Objectives



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